

Message Text

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P 062328Z APR 78
FM AMEMBASSY OTTAWA
TO SECSTATE WASHDC PRIORITY 6945
INFO AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY LONDON
AMEMBASSY PARIS
AMEMBASSY ROME
AMEMBASSY TOKYO
AMCONSUL MONTREAL
ALL OTHER CONGENS IN CANADA POUCH

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BRUSSELS FOR USEEC
PARIS ALSO FOR USOECD
DEPT. PASS TREASURY FOR SYVRUD, FRB, CEA

E.O. 11652:N/A
TAGS: ECON, EFIN, CA
SUBJECT: ECONOMIC OUTLOOK FOR CANADA IN 1978 - FORECAST
UPDATE

REF: OTTAWA 262

1. SUMMARY. EMBASSY HAS REVISED DOWNWARD FORECAST OF REAL
CANADIAN GNP GROWTH IN 1978 TO ABOUT THREE AND ONE HALF
PERCENT FROM FOUR PERCENT FORESEEN IN JANUARY, PRIMARILY
BECAUSE OF WEAKER OUTLOOK FOR PRIVATE INVESTMENT. DOWNSIDE
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RISK FOR SOME OTHER COMPONENTS OF GROWTH HAS INCREASED DUE
TO UNCERTAINTY CREATED BY RAPID RECENT DEPRECIATION OF
CANADIAN DOLLAR AND HIGHER INFLATION RISK. WE CONTINUE TO
SEE STRENGTH COMING MAINLY FROM CONSUMPTION AND NET EXPORT
GROWTH. BENEFITS TO EXPORTS FROM DEPRECIATION WILL PAR-
TIALY OFFSET WEAKER INVESTMENT. ESTIMATE OF MERCHANDISE
TRADE SURPLUS HAS BEEN REVISED UPWARD TO CDOLS 3.7 BILLION.

CURRENT ACCOUNT DEFICIT REVISED DOWN TO CDOLS 4.7 BILLION. MONETARY POLICY IS NOW FOCUSING ON EXCHANGE RATE TARGET. GNP DEFLATOR SHOULD RISE ABOUT 6.5 PERCENT, CPI ABOUT 7.5 PERCENT, AND AVERAGE UNEMPLOYMENT RATE WILL REMAIN ABOVE EIGHT PERCENT. END SUMMARY.

2. CONSUMPTION. WE CONTINUE TO BELIEVE REAL CONSUMPTION WILL RISE ABOUT 3.75 PERCENT. ESSENTIAL ELEMENTS ARE REAL AVERAGE EARNINGS UP 0.5 PERCENT, 2 TO 2.5 PERCENT RISE IN EMPLOYMENT, 3 TO 3.5 PERCENT RISE IN REAL DISPOSABLE INCOME, AND SMALL DROP IN SAVINGS RATIO. RETAIL SALES CONTINUE TO SHOW STRENGTH. FEDERAL INCOME TAX CUTS IN JANUARY AND FEBRUARY SUPPORTED CONSUMPTION SPENDING. HOWEVER, DOWNSIDE RISK IN CONSUMPTION FORECAST HAS INCREASED AS ANY REACCELERATION OF INFLATION FROM DEPRECIATION WOULD MILITATE AGAINST DECLINE IN SAVINGS RATIO AND REDUCE GROWTH OF REAL PERSONAL INCOME.

3. INVESTMENT. A NUMBER OF FACTORS HAVE ADDED GLOOM TO THE INVESTMENT OUTLOOK:

- MARCH SURVEY BY STATCAN INDICATED PRIVATE INVESTMENT WOULD RISE ONLY 5.6 PERCENT IN NOMINAL TERMS. AS CAPITAL GOODS PRICES COULD RISE BY EIGHT PERCENT, SURVEY WOULD INDICATE 2.4 PERCENT DECLINE IN REAL TERMS.
- REAL PRIVATE GROSS FIXED CAPITAL FORMATION DECLINED AT ACCELERATING RATE OF 11 PERCENT IN THE FOURTH QUARTER LIMITED OFFICIAL USE

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OF 1977 AND DECLINED 1.2 PERCENT FOR THE YEAR.

- RATE OF INDUSTRIAL CAPACITY UTILIZATION DECLINED IN FOURTH QUARTER. INDUSTRIAL PRODUCTION REMAINS WEAK, WITH JANUARY DOWN 1.1 PERCENT FROM DECEMBER AND BELOW LEVEL OF A YEAR EARLIER.

- USDOC SURVEY IN DECEMBER SHOWS U.S. FIRMS PLAN ONLY ONE PERCENT NOMINAL INCREASE IN INVESTMENT IN CANADA IN 1978 OVER LAST YEAR.

SURVEYS OF INVESTMENT INTENTIONS MAY WELL TURN OUT TO BE OVERLY PESSIMISTIC, ESPECIALLY IF U.S. AND OTHER ECONOMIES CONTINUE TO SHOW STRENGTH IN SECOND HALF OF THE YEAR, BUT ALL EVIDENCE SUGGESTS THAT REAL PRIVATE INVESTMENT IN CANADA WILL SHOW LITTLE IF ANY GROWTH THIS YEAR.

4. FISCAL POLICY. UNTIL RECENTLY THE FEDERAL GOVERNMENT HAS MAINTAINED IT WOULD BE INAPPROPRIATE TO INJECT SIGNIFICANT ADDED FISCAL STIMULUS BEFORE EFFECTS OF JANUARY/FEBRUARY TAX CUTS AND OTHER MEASURES CAN BE ASSESSED. PROVINCIAL BUDGETS WILL BE LARGELY CONSERVATIVE THIS YEAR. A FEDERAL BUDGET WILL BE BROUGHT DOWN THIS MONTH. WITH PROSPECTS OF A JUNE ELECTION, WEAK FIRST QUARTER INDICATORS, AND LOW LEVELS OF PUBLIC CONFIDENCE IN THE

ECONOMY, THE GOC MAY WELL DECIDE TO INTRODUCE MORE FISCAL STIMULUS IN BUDGET. IF SO, IT CAN BE EXPECTED TO EMPHASIZE ONE-SHOT TAX CUTS AND ADDITIONAL INVESTMENT INCENTIVES RATHER THAN MAJOR SPENDING INCREASES. SUCH A BUDGET WOULD NOT HAVE A MAJOR INFLUENCE ON ESTIMATES OF GOVERNMENT SPENDING IN 1978, NOW SEEN AS ABOUT 2.3 PERCENT IN REAL TERMS, BUT IT COULD BOLSTER DISPOSABLE INCOME AND EITHER RAISE CONSUMPTION FORECAST OR REDUCE DOWNSIDE RISK WE NOW ATTACH TO IT.

5. MONETARY POLICY. MONETARY POLICY OBJECTIVES HAVE SHIFTED TO FOCUS ON THE EXCHANGE RATE FOR THE TROUBLED CANADIAN DOLLAR. FROM 1975 TO EARLY THIS YEAR, MONETARY POLICY WAS CONDUCTED TO FIGHT INFLATION BY ANNOUNCEMENT OF LIMITED OFFICIAL USE

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MONEY SUPPLY (M1) TARGET RATES WHICH WERE ANNUALLY ADJUSTED DOWNWARD AND DEEMED SUFFICIENT TO ACCOMMODATE RATES OF ECONOMIC GROWTH ABOVE POTENTIAL AT DECLINING RATES OF INFLATION. THIS POLICY WAS PURSUED IRRESPECTIVE OF EFFECT

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ON THE EXCHANGE RATE. SHORT TERM INTEREST RATES WERE ADJUSTED BY THE BANK OF CANADA (BOC) WITH THE M1 TARGET IN MIND. THE ANNUAL RATE OF GROWTH OF M1 IS IN THE CURRENT TARGET RANGE OF 7 TO 11 PERCENT FROM A BASE OF JUNE, 1977.

6. THIS POLICY WAS MODIFIED BY INCREASES IN THE BANK (DISCOUNT) RATE ON MARCH 8 AND APRIL 3 (NOW AT 8.5 PERCENT WITH THE EXPRESSED INTENTION OF HELPING TO STABILIZE THE RAPIDLY DEPRECIATING EXCHANGE RATE. THE APRIL 3 BOC STATEMENT SAID A (DOWNWARD) EXCHANGE RATE ADJUSTMENT THAT WAS TOO LARGE OVER TOO SHORT A PERIOD OF TIME WOULD "NOT BE LIMITED OFFICIAL USE

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HELPFUL" IN RESTORING CANADA'S INTERNATIONAL COMPETITIVE POSITION ON A DURABLE BASIS BECAUSE OF THE RISK OF INFLATION. THE BANK SAID "FOR THE TIME BEING" IT WAS THEREFORE GIVING HIGH PRIORITY IN THE CONDUCT OF MONETARY POLICY TO THE EXTERNAL VALUE OF THE CANADIAN DOLLAR. MONEY SUPPLY TARGETS REMAIN IN PLACE, BUT MONETARY POLICY IS NOW EFFECTIVELY AND PUBLICLY ORIENTATED TOWARDS THE EXCHANGE RATE, NOT THE MONEY SUPPLY.

7. EXCHANGE RATE DEVELOPMENTS. WHILE THE CANADIAN DOLLAR WAS HELD UP IN 1976 BY HIGH INTEREST RATES TO BRING DOWN MONEY SUPPLY GROWTH (AND INFLATION), THE REVERSE WAS TRUE IN 1977. MONEY SUPPLY GROWTH WAS UNEXPECTEDLY SLUGGISH AND THE BANK OF CANADA BROUGHT DOWN SHORT TERM INTEREST RATES TO ENCOURAGE M1 EXPANSION AND HELP LAGGING ECONOMIC ACTIVITY. THE RESULT WAS ALMOST CONTINUOUS DEPRECIATION OF THE DOLLAR LAST YEAR AS INTEREST RATE DIFFERENTIALS AND RATES OF FOREIGN BORROWING DECLINED. THE CANADIAN DOLLAR DEPRECIATED 7.8 PERCENT IN 1977 WITH RESPECT TO THE U.S. AVERAGE OF 1.02 U.S. DOLLARS IN 1976. THIS DEPRECIATION WAS DEEMED DESIRABLE, DESPITE ITS INFLATIONARY IMPACT, TO HELP RESTORE CANADIAN EXPORT COMPETITIVENESS AND IMPROVE THE CURRENT ACCOUNT BALANCE. IT WAS WIDELY BELIEVED THE GOC HAD A TARGET LEVEL FOR THE CANADIAN DOLLAR OF ABOUT 90 CENTS TO ESTABLISH ADEQUATE COMPETITIVENESS.

8. THE CANADIAN DOLLAR DID NOT STABILIZE BUT REMAINED UNDER HEAVY DOWNWARD PRESSURE EARLY THIS YEAR DUE TO LULL IN LONG TERM EXTERNAL INFLOWS AUTONOMOUS BORROWING,

GENERALLY UNSETTLED INTERNATIONAL CURRENCY MARKETS, CONTINUED WEAK DOMESTIC ECONOMIC PERFORMANCE, POLITICAL UNCERTAINTY IN CANADA, AND OTHER FACTORS, DESPITE A WIDENING OF SHORT TERM INTEREST RATE DIFFERENTIALS BEGINNING LIMITED OFFICIAL USE

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IN LATE 1977. THE CANADIAN DOLLAR IS CURRENTLY TRADING AT BELOW 88 U.S. CENTS, A DEPRECIATION OF MORE THAN SIX PERCENT FROM THE AVERAGE LEVEL IN 1977.

9. IN THE FIRST ATTEMPT TO STABILIZE THE RATE, THE GOC "SENT THE MARKET A MESSAGE" IT WAS PREPARED TO MAINTAIN OR INCREASE INTERVENTION BY ANNOUNCING IN OCTOBER ESTABLISHMENT OF A 1.5 BILLION (INCREASED IN MARCH TO 2.5 BILLION) EURO-U.S. DOLLAR SHORT TERM CREDIT FACILITY WITH CANADIAN CHARTERED BANKS. WITH HEAVY RESERVE LOSSES IN FEBRUARY AND THE DOLLAR SINKING BELOW 90 CENTS, THE GOC DREW U.S.DOLS 750 MILLION FROM THIS FACILITY IN MARCH, AND ALSO FLOATED A 750 MILLION BOND ISSUE IN NEW YORK, IN ADDITION TO THE TWO INCREASES IN THE BANK RATE. THE GOC HAS ANNOUNCED IT WILL UNDERTAKE FURTHER FOREIGN BORROWING TO THE EXTENT REQUIRED TO REPLENISH ITS INTERNATIONAL RESERVES USED IN DEFENSE OF THE EXCHANGE RATE TO SUPPLEMENT THE NET INFLOW OF CAPITAL TO CANADA THAT FINAN-

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CES ITS CURRENT ACCOUNT DEFICIT.

10. FURTHER DOWNWARD PRESSURE ON THE CANADIAN DOLLAR CAN BE EXPECTED THIS YEAR. EXCHANGE MARKET TURBULENCE COULD TAKE PLACE IN COMING WEEKS DUE TO UNCERTAINTY PRIOR TO PRESENTATION OF THE FEDERAL BUDGET LATER THIS MONTH. FOR THE YEAR AS A WHOLE, LONG TERM INFLOWS IN THE FORM OF FOREIGN BORROWING, INCLUDING THE U.S.DOLS 750 MILLION GOC BOND ISSUE, ARE EXPECTED TO BE IN THE RATE OF AT LEAST U.S.DOLS 5 BILLION -- I.E., GREATER THAN THE EXPECTED CURRENT ACCOUNT DEFICIT (SEE BELOW). HOWEVER, FURTHER "LULLS" IN FOREIGN BORROWING ARE POSSIBLE. UNCERTAINTY AND A DRYING UP OF BORROWING CAN BE EXPECTED PRIOR TO THE PLANNED REFERENDUM IN QUEBEC ON SOVEREIGNTY, (ALTHOUGH THAT MAY NOT COME ABOUT UNTIL NEXT YEAR). WE BELIEVE FURTHER GOC FOREIGN BORROWING IN SOME FORM IS LIKELY LATER
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THIS YEAR DUE TO THE POSSIBILITY OF PERIODS OF MARKET PRESSURE ON THE CANADIAN DOLLAR AND OFFICIAL DETERMINATION TO RESIST SHARP DOWNWARD MOVEMENTS.

11. INFLATION. CONSUMER PRICES SHOULD RISE ABOUT 7.5 PERCENT THIS YEAR, DOWN FROM 8.0 PERCENT IN 1977 WHEN FOOD PRICES INCREASED SHARPLY. THE GNP DEFLATOR SHOULD RISE ABOUT 6.5 PERCENT. SLACK LABOR MARKETS, CONTINUED GROWTH BELOW POTENTIAL, PUBLIC NERVOUSNESS ABOUT CANADA'S INTERNATIONAL COMPETITIVENESS POSITION AND ECONOMIC HEALTH, PLUS SOME GOVERNMENT JAWBONING WILL PROBABLY KEEP WAGE SETTLEMENTS AND UNIT LABOR COSTS RISING AT RATES NO WORSE THAN LAST YEAR. SOME SLIGHT CONTINUATION OF THE DOWNWARD TREND IN LABOR COSTS IS POSSIBLE. HOWEVER, DEPRECIATION SINCE JANUARY ADDS TO THE UPSIDE RISK IN THE INFLATION FORECAST DUE TO THE IMPORT COMPONENT OF INFLATION ITSELF AND UNWILLINGNESS OF WORKERS TO ACCEPT SMALLER THAN EXPECTED REAL INCOME GAINS.

12. LABOR MARKETS AND UNEMPLOYMENT. IF PARTICIPATION RATES DO NOT RISE FURTHER, LABOR FORCE GROWTH SHOULD BE SOMEWHAT LOWER THAN LAST YEAR. SEASONALLY ADJUSTED UNEMPLOYMENT RATES DECLINED FROM A RECENT HIGH OF 8.5 PERCENT IN DECEMBER TO 8.3 IN JANUARY AND FEBRUARY. THE AVERAGE UNEMPLOYMENT RATE FOR THE YEAR WILL BE ABOUT 8.2 PERCENT. HOWEVER, IF THE PARTICIPATION RATE CONTINUES TO RISE,

AVERAGE UNEMPLOYMENT WILL BE CONCOMITANTLY HIGHER -- IN
REGION OF 8.5 PERCENT.

13. MERCHANDISE TRADE BALANCE.

A. EXCHANGE RATE EFFECTS. DEPRECIATION OF CANADIAN DOLLAR
SINCE JANUARY WILL LIKELY HAVE ADVERSE SHORT-RUN "J CURVE"
EFFECT ON MERCHANDISE BALANCE AS CHANGE IN IMPORT VOLUME
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LAGS HIGHER IMPORT PRICES, BUT THIS WILL BE MORE THAN
OFFSET DURING YEAR BY CONTINUING POSITIVE EFFECTS ON
BALANCE OF DEPRECIATION OVER THE PAST 12 TO 17 MONTHS.
DEPRECIATION SHOULD ALSO ACT TO INCREASE EXPORT PRICES
IN CANADIAN DOLLARS, ESPECIALLY SINCE THE STRUCTURE OF
INTERNATIONAL MARKETS IS BELIEVED TO MEAN SOME CANADIAN
EXPORTERS ARE PRICE TAKERS IN U.S. DOLLARS IN THE SHORT
RUN.

B. INCOME EFFECTS. CONTINUATION OF FASTER ECONOMIC
GROWTH IN U.S. THAN IN CANADA WILL ALSO HELP INCREASE
CANADIAN MERCHANDISE SURPLUS, BUT TO A LESSER DEGREE THAN
LAST YEAR AS THE DIFFERENCE IN GROWTH RATES NARROWS. THE
COMPOSITION OF U.S. GROWTH WILL ALSO BE IMPORTANT. ANY
CONTINUED WEAKNESS IN U.S. AUTO DEMAND EVIDENT EARLY THIS
YEAR WOULD HURT CANADIAN AUTO SECTOR EXPORTS, WHICH ARE
22 PERCENT OF TOTAL MERCHANDISE EXPORTS. ON THE OTHER
HAND, INCREASE IN U.S. INDUSTRIAL CAPACITY UTILIZATION
RATES, AND ANY U.S. BUILD-UP OF INDUSTRIAL INVENTORIES
WILL HELP CANADIAN EXPORTS OF INDUSTRIAL MATERIALS BEYOND
DIRECT U.S. INCOME EFFECTS. INDUSTRIAL MATERIALS REPRESENT
ABOUT 53 PERCENT OF CANADIAN EXPORTS.

C. TAKEN TOGETHER, EMBASSY ESTIMATES VOLUME OF EXPORTS
SHOULD INCREASE BY OVER 5 PERCENT AND VALUE BY 14 PERCENT
TO CDOLS 50.6 BILLION. IMPORT VOLUMES MAY RISE ABOUT 3
PERCENT AND IMPORT PRICES 9.5 PERCENT FOR A 13 PERCENT
INCREASE IN THE VALUE OF IMPORTS TO CDOLS 46.9 BILLION.
MERCHANDISE TRADE SURPLUS SHOULD THUS BE ABOUT CDOLS 3.7
BILLION.

14. SERVICE BALANCE. THE SERVICE BALANCE AS USUAL WILL

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BE DOMINATED BY THE DEFICIT IN INTEREST AND DIVIDEND PAYMENTS AND THE TRAVEL DEFICIT.

A. INTEREST AND DIVIDEND PAYMENTS ABROAD WILL INCREASE BY THE SERVICING ON THE DOLS 5.2 BILLION BORROWED ABROAD IN 1977, PLUS THE HIGHER LOCAL CURRENCY COST OF SERVICING THE OUTSTANDING EXTERNAL DEBT DUE TO DEPRECIATION. THERE MAY ALSO BE SOME INCREASE IN DIVIDEND PAYMENTS ABROAD AT THE END OF THIS YEAR AS PROFIT AND DIVIDEND CONTROLS ARE LIFTED. PAYMENTS WILL BE ABOUT CDOLS 5.1 BILLION AND RECEIPTS ABOUT .9 BILLION FOR A DEFICIT OF ABOUT CDOLS 4.2 BILLION.

B. GROWTH OF THE TRAVEL DEFICIT SHOULD SLOW DUE TO HIGHER FOREIGN CURRENCY COSTS OF FOREIGN TRAVEL AND CHEAPER TRAVEL COSTS IN CANADA FOR FOREIGNERS. HOWEVER, THE DEFICIT SHOULD CONTINUE TO RISE SOMEWHAT DUE TO THE LOW CANADIAN LIMITED OFFICIAL USE

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PRICE ELASTICITY OF DEMAND FOR WINTER VACATIONS. EFFORTS TO ENCOURAGE DOMESTIC TRAVEL BY CANADIANS HAVE SO FAR BEEN LIMITED AND HAVE HAD LITTLE VISIBLE SUBSTITUTION EFFECT FOR FOREIGN TRAVEL. THE TRAVEL DEFICIT SHOULD THUS BE ON THE ORDER OF CDOLS 2 BILLION.

C. THE SERVICE DEFICIT FOR TRANSPORT, WITHHOLDING TAXES, AND OTHER SERVICE TRANSACTIONS WILL BE ABOUT CDOLS 2.7 BILLION.

15. CURRENT ACCOUNT. WITH NET TRANSFERS ESTIMATED AT

ABOUT CDOLS 500 MILLION, THE CURRENT ACCOUNT DEFICIT SHOULD BE ABOUT CDOLS 4.7 BILLION.

SUMMARY TABLES

A. GNP AND COMPONENTS, MILLIONS OF CONSTANT 1971 DOLLARS.

PERCENT CHANGES (SHOWN IN BRACKETS):

-----	1977P	1978F
PRIVATE CONSUMPTION	77,186	80,080
(2.8) (3.8)		
PRIVATE INVESTMENT	22,777	23,004
(-1.2) (1)		
GOVERNMENT SPENDING	26,248	26,883
(2.3) (2.4)		
INVENTORIES	- 64	400
FOREIGN BALANCE'	-4,693	-4,482
FINAL DEMAND	121,630	125,485
(3.8) (3.3)		
RESIDUAL ERROR	112	---
GNP	121,566	125,885
(2.6) (3.6)		

1NET EXPORTS OF GOODS AND SERVICES.

B.SELECTED INDICATORS;

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CPI	8.0	7.5
GNP DEFLATOR	6.6	6.5
UNEMPLOYMENT RATE	8.1	8.2

C. CURRENT ACCOUNT BALANCE, BILLIONS OF CANADIAN DOLLARS, BRACKETS () INDICATE DEFICIT.

-----	1977P	1978F
MERCHANDISE TRADE	2.9	3..7
SERVICE BALANCE	(7.5)	(8.8)
OF WHICH:		
- INTEREST AND DIVIDENDS	(3.4)	(4.2)
- TRAVEL	(1.7)	(1.9)
- OTHER	(2.4)	(2.7)
BALANCE OF GOODS AND SERVICES	(4.6)	(5.1)
CURRENT ACCOUNT	(4.2)	(4.7)
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